11. CROATIA

Growth gathering steam

A strong and broad-based recovery pushed real output up by an estimated 2.8% in 2016. Growth is projected to strengthen in 2017 and moderate in 2018. Robust domestic demand supports a steady import growth and the current-account surplus is projected to contract to 1.3% of GDP by 2018. Unemployment is set to continue to fall, though at a slower pace as the labour force broadly stabilises. The general government deficit is seen up to 2.1% of GDP in 2017, with a significant deterioration in the structural balance.

The economic recovery accelerated in 2016

At 1.7% (q-o-q), GDP growth in the third quarter was higher than expected in autumn. All components of domestic demand contributed to this strong performance. While exports of goods suffered a temporary setback, exports of services jumped by 3.5% q-o-q due to another strong tourist season. Growth likely decelerated in the fourth quarter of 2016, but all in all, Croatia's economy is expected to have grown by a solid 2.8% in 2016.

Growth set to gather pace in 2017, and slow down thereafter

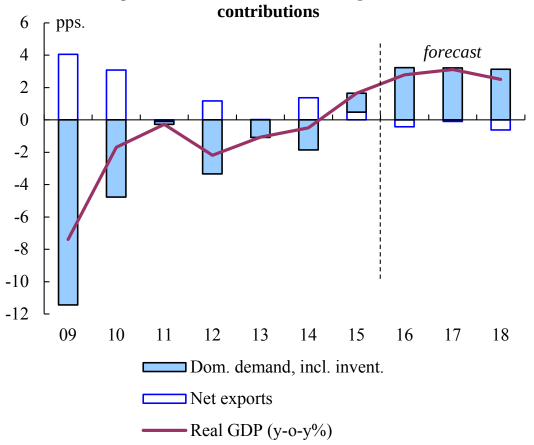
The strong growth momentum gathered in the second half of 2016 is projected to carry over to 2017 and receive extra impetus from the government's expansionary fiscal stance. Consumption, in particular, is projected to benefit from tax cuts and expand by 3.4%. Corporate investment is projected to rebound, as ample liquidity and favourable financing conditions support credit expansion. EU investment funds are expected to provide an additional boost to public investment. Government consumption is set to grow more moderately, but overall domestic demand is expected to drive real GDP growth. Export growth is expected to slow down somewhat, especially in services, while the strength of domestic demand is expected to underpin steady import growth. As a result, net exports are projected to detract from growth. Overall, real GDP is expected to grow by 3.1% in 2017.

The positive trend in consumption is set to continue in 2018 but moderate slightly as the boost from tax cuts lessens. Investment, on the other hand, is projected to remain strong also thanks to abundant liquidity. The external environment is set to remain supportive, but as export market shares stabilise following the substantial gains since EU accession, export growth is set to slow. Import growth, on the other hand, is expected to remain vigorous. This, combined with a rebound in import prices both in 2017 and 2018, is set to contribute to a further erosion of the current-account surplus, to about 1.3% of GDP in 2018.

Risks to these growth forecasts are tilted to the downside and are mainly related to a possible deterioration of the external environment and a tightening of monetary policy. At the same time, the positive trend in goods exports and tourism could continue also in 2017 and 2018, with further significant gains in export market shares.

G

Graph II.11.1: **Croatia - Real GDP growth and contributions**



Inflation pressures to reappear as unemployment falls and import prices rebound

Unemployment is expected to have decreased by more than 3 pps. in 2016, due to the continued shrinking of the labour force but also increasing employment. By 2018, the unemployment rate is projected to drop to 9.3%, as employment continues to recover, while the labour force broadly stabilises around current levels. After several years of restraint, average compensation of employees is estimated to have risen by 1.7% in 2016 and should accelerate to around 2.4% in 2017. This, together with higher import prices, is projected to push inflation to about 1.7% this year, confirming the turnaround in price dynamics observed in the last months of 2016. Inflation is projected to slightly decelerate in 2018, as the recovery in energy prices slows down.

Deficit set to rise from a record low as tax reforms cut revenue

Croatia's general government deficit is expected to have decreased significantly to 1.8% of GDP in 2016, largely on the back of windfall revenues and contained expenditure growth. Growth in primary expenditure in 2016 is expected to have remained below nominal GDP growth. The headline deficit is projected to increase in 2017 to 2.1% of GDP due to the impact of tax reforms, but improve again in 2018. In particular, the tax reforms have increased the personal allowance and decreased personal income tax rates. In corporate income tax, the general rate was decreased and a reduced rate was introduced, but the tax base is increased through the abolition of some tax breaks and exemptions. In VAT, categories of goods and services were shuffled between the existing rates. The direct effect on tax revenues is expected at 0.6% of GDP in 2017 and 0.2% in 2018, with the bulk of the reduction coming from cuts in the personal income tax and, to a lesser extent, VAT. The total cost of the reform is however expected to be partially offset by the stronger growth, as the tax cuts boosts consumption and investment.

The revenue-reducing impact of the tax reforms and the projected increase in expenditure indicates an expansionary fiscal stance. After a marked improvement in 2016, the structural balance is forecast to deteriorate by about 1½% of GDP in 2017 and close to ½% of GDP in 2018.

The debt ratio is projected to have shrunk in 2016 (from 86.7 to 84.1% of GDP) thanks to a combination of strong growth, fiscal consolidation, appreciation of the kuna against the euro and favourable refinancing conditions. The debt ratio is projected to keep falling over the forecast horizon, but more moderately, as the effect of fiscal consolidation and appreciation of the kuna against the euro fade out.

Table II.11.1:

Main features of country forecast - CROATIA

	2015			Annual percentage change						
bn HRK		Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		333.8	100.0	2.1	-1.1	-0.5	1.6	**2.8**	**3.1**	**2.5**
Private Consumption		196.2	58.8	2.0	-1.8	-1.6	1.2	**3.0**	**3.4**	**3.0**
Public Consumption		65.8	19.7	1.6	0.3	-0.8	-0.3	**1.4**	**1.0**	**1.0**
Gross fixed capital formation		65.1	19.5	3.5	1.4	-2.8	1.6	**4.2**	**5.2**	**5.8**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		166.8	50.0	4.0	3.1	7.6	10.0	**4.9**	**4.7**	**4.3**
Imports (goods and services)		157.7	47.2	3.7	3.1	4.5	9.4	**6.1**	**5.2**	**5.8**
GNI (GDP deflator)		333.2	99.8	1.9	0.2	-1.8	4.2	**0.2**	**3.1**	**2.4**
Contribution to GDP growth:	Domestic demand			2.5	-0.7	-1.7	1.0	**2.9**	**3.2**	**3.1**
	Inventories			0.0	-0.3	-0.2	0.2	**0.4**	**0.0**	**0.0**
	Net exports			-0.3	0.0	1.4	0.5	**-0.4**	**-0.1**	**-0.6**
Employment				-0.2	-2.7	2.7	1.5	**1.9**	**2.1**	**1.6**
Unemployment rate (a)				-	17.3	17.3	16.3	**12.8**	**10.8**	**9.3**
Compensation of employees / head				6.3	-0.6	-5.4	-0.3	**1.7**	**2.4**	**2.5**
Unit labour costs whole economy				3.9	-2.3	-2.4	-0.5	**0.9**	**1.4**	**1.5**
Real unit labour cost				0.0	-3.0	-2.4	-0.6	**0.2**	**0.6**	**-0.3**
Saving rate of households (b)				-	10.5	12.8	14.1	**12.8**	**12.5**	**11.3**
GDP deflator				3.9	0.8	0.0	0.1	**0.7**	**0.9**	**1.8**
Harmonised index of consumer prices				-	2.3	0.2	-0.3	**-0.6**	**1.7**	**1.6**
Terms of trade goods				1.3	-1.6	-0.9	-0.8	**0.4**	**-1.9**	**0.0**
Trade balance (goods) (c)				-19.0	-15.1	-14.8	-15.2	**-15.2**	**-16.4**	**-17.2**
Current-account balance (c)				-4.4	1.6	1.1	5.0	**2.8**	**1.8**	**1.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-4.4	1.6	1.1	5.5	**3.8**	**2.9**	**2.4**
General government balance (c)				-	-5.3	-5.4	-3.3	**-1.8**	**-2.1**	**-1.8**
Cyclically-adjusted budget balance (d)				-	-3.4	-3.4	-2.1	**-1.3**	**-2.7**	**-3.2**
Structural budget balance (d)				-	-3.2	-3.6	-2.1	**-1.4**	**-2.8**	**-3.2**
General government gross debt (c)				-	82.2	86.6	86.7	**84.1**	**83.0**	**81.3**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.